American Heritage
FEDERAL CREDIT UNION

August 27, 2015

AUG31'15 PM 2:07 BOARD

Mr. Gerard S. Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Comment Letter on the Proposed Amendments to NCUA's MBL Rule

Dear Mr. Poliquin:

American Heritage Federal Credit Union (AHFCU) is pleased to comment on NCUA's Notice of Proposed Rulemaking for 12 CFR Part 723 regarding potential changes to the Member Business Loan regulations. We commend the Board on considering these regulations to assist credit unions in better serving their business members' expanding needs.

AHFCU is a low-income designated credit union serving the county of Philadelphia, PA as well as 800+ select employee groups in Pennsylvania. We have nearly 139,000 members and over $1.5 billion in assets.

Our comment letter is segmented into three sections, as follows:

- Commendations on the Proposed Regulation;
- Specific items where AHFCU recommends earlier implementation timing;
- Items where AHFCU recommends further clarification or modification by NCUA.

Commendations on the Proposed Regulation

First, we commend the proposed regulation and NCUA's shift from prescriptive regulation to a principles-based approach. There are a wide variety of credit union MBL programs in the industry, and this approach allows each credit union to tailor the program to fit its strategic goals and risk tolerances.

We also commend the elimination of the minimum two-year experience requirement for underwriting MBLs. The variation in complexity makes one standard difficult, if not impossible, to identify and use for all circumstances. AHFCU is an owner of Member Business Financial Services, LLC,a MBL CUSO formulated to assist credit unions in meeting this requirement. Frankly, AHFCU has been of the opinion that two years of experience is not enough to underwrite certain loans and manage the risks of a portfolio. The change requiring experience commensurate with specific loan underwriting and portfolio risk is a positive step forward.

Along the same lines, we also commend the need for senior executives to have a comprehensive understanding of the risks of a commercial lending program. AHFCU has always viewed this as paramount to the long-term success of a MBL program.

Specific Items Where AHFCU Recommends Earlier Implementation Timing

The Proposed Regulation states that an 18 month implementation timeline will be required before the regulation goes into effect. We understand the need for credit unions and examiners to understand and implement regulatory changes. However, we believe that this extended timeline is unwarranted for certain items that are relatively simple. These changes will have a positive, material impact on not only AHFCU, but all credit union MBL programs and put credit unions on a level playing field with banks and other financial institutions. These can be easily implemented by updating the business lending policy and making appropriate changes in procedures. Examples of practices that can be enacted more expeditiously include:

Credit Risk Rating System – AHFCU as well as most credit unions already have a credit risk rating system in place and simply need to shore up measurement and reporting. Those that do not have a robust system can establish and implement one as an integral part of their MBL policy update. [Reference Proposed Regulation 723.4(g)(3)]

Construction Loan Soft Costs – The regulatory definition that specifically identifies which costs may be included in construction soft costs is now clear, and this change can be implemented in a credit union's policy and practices right away. [723.6(b)(1)]

Loan to Value Definitions for Construction Loans – The new definitions that require using the lower of (1) the cost to build or (2) either the projected "as-stabilized" or "as completed" values, are now clear and can be implemented in a credit union's policy and practices immediately. [723.6(b)(2)]

Unsecured Lending – Credit unions can relatively easily define circumstances where appropriate and well-supported unsecured lending limits can be utilized. Credit unions can also set unsecured loan limits for loans to one borrower and portfolio limits that tie to net worth. These can be established in a credit union's policy and practices in a relatively short time period. [723.5(a)]

Loans to One Borrower Limit – The new regulatory definition will allow a credit union to exceed the current 15% of net worth limit by an additional 10%, as long as the higher advance is fully secured by marketable securities or cash accounts. This is clear and can be quickly implemented in a credit union's policy and practices. [723.4(c)]

Personal Guaranties – AHFCU agrees with the Preamble to the Proposed Rule in that credit unions should always obtain full personal guaranties whenever possible. While eliminating guaranties does pose additional risk, we believe this change can be implemented sooner in various ways. Credit unions could revise their policies to require a graduated scale for guaranties, where they would use other limited guaranty options before waiving a personal guaranty altogether. For example, credit unions are often asked to allow proportional guaranties when a business or property is owned by several individuals. Permitting this limited guaranty is a better alternative than declining a well-supported loan request when the owners are not willing to provide joint and several guaranties. Another graduated scale option would be to allow "carve-out" guaranties that would give the credit union the ability to pursue these limited guaranties for certain acts of default, such as the borrower filing bankruptcy. A third option is to require a guaranty only from the guarantor that is key to the success of the business, e.g. a managing partner, even though that guaranty percentage is below the 51% required today. [723.5(b)]

In our opinion, <u>the guaranty issue is clearly the most important timing change that should be made in the new regulation</u>. Credit unions today are forced to turn away many excellent lending opportunities because of the regulation-mandated guaranties, and 18 months is far too long to wait for this change.

<u>Items Where AHFCU Recommends Further Clarification or Modification by NCUA</u>

From our view, other provisions of the Proposed Regulation still need further clarification or definition, as follows:

<u>Common Enterprise and Control</u> – The Proposed Regulation is quite specific on the definitions and stated percentages for determining borrower associational relationships. We question why this section of the new regulation seems to be more prescriptive rather than less so, as this portion of the new rule seems to run counter to the Control definition that should drive the Associated Borrower rules. In particular, the 50% Common Enterprise Rule and the 25% Control Rules are quite specific. We believe credit unions should be allowed to take a conservative approach and count any borrower who has a joint interest with another borrower or entity as an Associate Borrower. In addition, credit unions should be able to use prudent judgment to determine who has Control, as was suggested in Exhibit 3 of the *2013 Supervisory Letter on Evaluating Credit Union Requests for Waivers of Provisions in NCUA Rules and Regulations Part 723, Member Business Loans.* [723.2 and 701.22(a)]

<u>Calculation of the MBL Cap</u> – The Proposed Regulation eliminates the 12.25% of assets Cap, with the sole definition of the MBL Cap changed to "the lesser of 1.75 times a credit union's net worth or 1.75 times the minimum net worth requirement to be considered well-capitalized." We would request a clarification of what is intended by this change. Will the 7.0% definition of well-capitalized (under §1790d(c)(1)(A)(i) of the Federal Credit Union Act remain in place, or will the paragraph that follows [§1790d(c)(1)(A)(ii)] leave room to redefine "well-capitalized" at a higher level once the pending Risk Based Capital rules go into effect? The former interpretation would seem to leave most credit unions' current Portfolio Caps in place. However, if there is a higher threshold for well-capitalized under RBC, it may allow for more space under the MBL Cap. Naturally, most credit unions would prefer the second option to take effect. [723.8(a)]. Regardless, in our particular case, as a Low Income Designated credit union, we are afforded a waiver from the MBL Cap.

<u>State Regulations on Loan to Value</u> – The Proposed Rule calls for each credit union to set its own loan to value limitation by product type while maintaining adequate collateral

cushions. However, no maximums are set in the regulation, which may bring some credit unions into conflict with state regulations that do have maximum loan to value ratios. This potential conflict would not be limited to only the seven states that have their own MBL regulations, but could also apply to many state chartered credit unions. NCUA could have the Proposed Regulation direct the credit unions to set their LTV limits no higher than allowed by their respective state regulations. [723.4(f)(5) and 723.5(a)]

Classification of an MBL vs. Commercial Loan – In reading the Proposed Regulation, loans that are included and excluded in these two definitions seems too complex, to the point where it appears NCUA is creating exceptions to the exceptions. If the new definitions need to remain as shown in the Proposed Regulation for call reporting purposes, we would recommend the table found on page 56 of the Proposed Regulation Preamble be included in the finalized version of Section 723. This would provide the needed guidance to both credit unions and regulators when determining underwriting standards and call report classification of a loan. [723.8(a)]

Non-Member Participations – The Proposed Rule excludes these from the MBL Cap and each credit union can set its own portfolio limit on the amount of non-member participation loans that can be purchased. Therefore, a credit union could potentially buy as many non-member participations as desired. This is good for geographic diversification and balance sheet management. However, these participations are most often far outside a credit union's geographic field of membership or home state. From a safety and soundness perspective, it would seem to carry more risk for a credit union to hold a large amount of its portfolio in non-member participations, while they are constrained by the MBL Cap on member business loans within their core market area. Accordingly, we would suggest the Final Rule include similar direction to what was provided to the banking industry by their regulators in the *2006 Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. In that publication the OCC, FRB, and FDIC strongly suggested commercial real estate concentrations held by banks be limited to 300% of net worth and construction loan concentrations be limited to 100% of net worth. The Interagency Guidance did not mandate these levels though, but went on to indicate that failure to abide by these limits could subject the offending institution to increased regulatory scrutiny. A recent regulatory review paper validated these thresholds by reviewing bank failures during the Great Recession, concluding that many banks with high levels of non-owner occupied commercial real estate loans either failed or threatened safety and soundness as commercial real estate market valuations significantly declined.

Of course, there will need to be exceptions to this general guidance, specifically for those credit unions that have been grandfathered in with no MBL Cap. [723.8]

Prepayment Penalties – We feel it is necessary to bring up one issue that was not directly addressed in the Proposed Rule, but which we believe warrants high consideration by the NCUA for regulatory revision. Federally chartered credit unions are prohibited by regulation from having a prepayment penalty on any type of loan. AHFCU understands the rationale for prepayment penalties to exist in consumer lending. However, business lending is very different and is most often a longer, more costly process requiring specialized expertise and systems. The investment made in originating and managing a commercial real estate loan, for example, will typically be thousands of dollars in staff time, systems, and third party costs.

If a business member takes out a commercial real estate loan with no prepayment penalty, then refinances or pays off that loan a few months later, the credit union which by regulation, could not charge a prepayment penalty, has not had sufficient time to earn interest and recoup the high costs of making the loan. This results in an economic hardship for the credit union that was strictly caused by regulations. Many state chartered credit unions can charge prepayment penalties, yet federally chartered credit unions cannot. This uneven playing field within our own industry is difficult to understand.

We do understand that NCUA regulations allow for a "cost recovery" clause, which acts similar to a prepayment penalty. In practice, this is rarely, if ever, used. It is confusing to credit unions and certainly to borrowers, versus a prepayment penalty which is standard practice in commercial lending. Frankly, the cost recovery clause does not substitute for even the most simple prepayment penalty.

We suggest that an easy solution to rectify this unintended regulatory burden is to allow loans defined as Member Business Loans under Regulation 723 to be exempt from the prepayment penalty prohibition. We respectfully request that the NCUA consider this important revision to the Proposed Regulation. [701.21(c)(6)]

Final Comments

We are concerned that the principles-based approach will rely in large part on subsequent "Supervisory Guidance" that will be used by examiners to interpret the Final Rule and carry out MBL exams. We would like to see a comment period be provided to allow transparency for credit unions to understand how the guidance is being presented. Without a comment period, the industry will have no input on how this guidance is put together and may not understand or interpret the guidance in the same way examiners do. It is imperative for credit unions to fully understand the areas of emphasis and expectations examiners will be focusing on in their work. [Reference: Page 36 of Preamble to Proposed Regulation]

Another area of concern is that the principles-based approach will require a tremendous amount of judgment by field examiners. NCUA has improved expertise and exam consistency over the past decade, but it will be essential to continue to develop true commercial lending expertise in examiners, as well as ensuring consistency in all credit union examinations.

Our final are of concern is related to the projected cost associated with training the field examiners regarding this new rule. It is our hope that the cost will be reallocated from the current training budget and not be added as a new expense since these costs are ultimately paid for by our members.

We sincerely appreciate the opportunity to provide input on NCUA's proposed rulemaking amending the Member Business Loan regulations. Feel free to contact me for clarification or further discussion on any of these important items.

Sincerely,

Bruce K. Foulke

Bruce K. Foulke
President/CEO